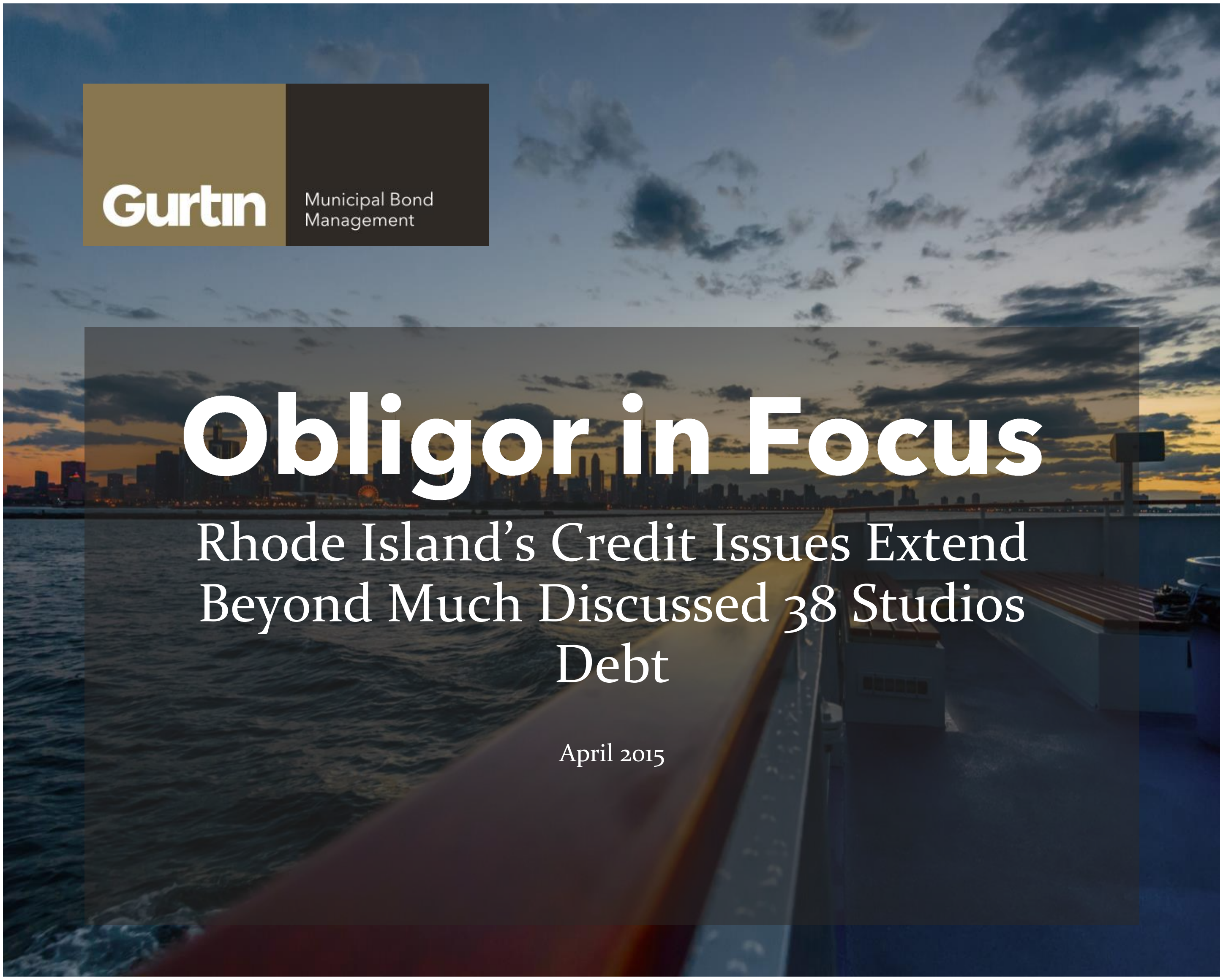

Gurtin Municipal Bond Management

Obligor in Focus

Rhode Island's Credit Issues Extend Beyond Much Discussed 38 Studios Debt

April 2015

Executive Summary

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State's economic and demographic trends continue to be poor

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In May of 2014 Gurtin Municipal Bond Management placed a Sell rating on the State of Rhode Island, and as a result, we have no exposure to the State's debt for our clients. While our downgrade was mainly due to the State's consideration of repudiating moral obligation secured debt tied to a controversial and failed economic development project, the State's credit quality also faces an array of economic and fiscal challenges that extend beyond persistent concerns that the State will again question its stance on the aforementioned moral obligation bonds.

Governor Gina Raimondo of Rhode Island recently released her proposed fiscal year 2016 budget. Like prior budgets from the State, it was released under heavy scrutiny due to the controversy surrounding 38 Studios. As you may recall, in an effort to entice the fledgling video game company founded by Red Sox pitching star Curt Schilling to relocate their headquarters to Rhode Island from neighboring Massachusetts, in 2010 the State decided to place its moral obligation behind a series of debt issued for 38 Studios.[1] As the saying goes, "be careful what you wish for." While the State was victorious in its effort to attract 38 Studios, by 2012, the company had declared bankruptcy. Stung by the rapid decline of the company and the high profile nature of the founder, angry legislators considered repudiating the debt, thereby, calling the State's moral obligation pledge into question.[2]

Importantly, the Governor's proposed 2016 budget does appropriate funds to support the 38 Studios debt. Due to the nature of the moral obligation security and the bankruptcy of the company, Rhode Island must go through the legislative process of appropriating the funds for 38 Studios debt each budget cycle until the debt is finally retired in 2021. During past budget cycles, the appropriation of funds has been highly debated, but ultimately agreed upon. Given the debt's highly contentious history, we remain concerned that, due to expectations of ongoing fiscal woes, the legislature will continue to search for opportunities to reduce expenditures, and, as such, the 38 Studios appropriation will remain an issue for the foreseeable future. While this research piece focuses on the broader issues facing the State of Rhode Island, for additional information on the 38 Studios story, please refer to our prior report which provides a detailed explanation of the events and answers frequently asked questions about the incident and its potential incendiary consequences – FAQ: Rhode Island's Near Repudiation of 38 Studios Bonds

[1] Officially issued as The Rhode Island Economic Development Corporation Job Creation Guaranty Program Taxable Revenue Bonds, Series 2010
[2] "Rhode Island House GOP Leader: Don't Pay 38 Studios Bonds," The Bond Buyer (June 20, 2013)

Rhode Island has historically relied on gaming revenues as a budget cure-all; given recent trends, the State will likely need to find new and sustainable fiscal solutions.

Rhode Island's budget has faced chronic shortfalls, with General Fund revenues falling short of expenditures in each of the past five fiscal years. The State has addressed the structural deficits by deploying the same silver bullet each year, transferring gaming revenue proceeds into the general fund. In fiscal year 2014, gaming revenues comprised roughly 11% of all State general revenues, making Rhode Island second only to Nevada in its reliance on gaming revenues.[3] Unfortunately, this crucial fiscal lifeline is becoming increasingly unreliable. Massachusetts' recent decision to legalize gaming coupled with a national trend of softening lottery and gaming laws is expected to siphon off a significant percentage of gaming activity currently flowing into Rhode Island.[4]

[3] Financial figures are taken from the "State of Rhode Island Comprehensive Annual Financial Report: fiscal year ended June 30, 2014"
[4] Rhode Island's lottery revenues fell by 8.3% in FY14 from FY13, and total gaming revenues fell by 0.3% in FY14. Source: Rockefeller Institute of Government, "State Revenues from Gambling Show Weakness Despite Gambling Expansion," March 23, 2015.

The most recent semiannual revenue estimate from the Rhode Island State Budget Office, Senate Finance, and House Finance Committee during their semiannual Revenue Estimating Conference (REC) from November 2014, predicts a 30-40% decline in gaming revenue by 2020. A decline of this magnitude will strip Rhode Island of its ability to plug general fund gaps with gaming revenue. The pain, however, may begin much sooner than 2020, as Massachusetts expects the first wave of casinos to open in 2017. Rhode Island is now faced with the prospect of uncovering additional revenue sources to not only ease the pain of lost gaming income, but also to offset expenditure growth that is projected to continue to outpace traditional revenue growth.

The Governor's most recent budget projects deficits in each of the next five years, ultimately culminating with a $400 million plus deficit in fiscal year 2019 (over 10% of its budget size). The catalysts of the State's expenditure growth are expected to be concentrated into two main categories: Medicaid and pensions, both of which are notoriously challenging for states to reduce. As an acknowledgement of the burden being placed on the State in the form of rising Medicaid payments, Governor Raimondo has commissioned an advisory group with the sole purpose of making the program more efficient. At current spending levels, Rhode Island has the second highest cost per enrollee in the nation. In regard to rising pension payments, Rhode Island has acted to control expenditure growth by passing the Rhode Island Retirement Security Act of 2011 (RIRSA). When enacted, RIRSA is estimated to save taxpayers $4 billion over the following three decades.[5] The reforms included in the legislation were recently challenged in the State's Superior Court, and at the time of this report, a Rhode Island Superior Court Judge had announced a settlement between the State and majority of unions preserving many key implementations of RIRSA. Although the settlement has been agreed upon by most unions in the State, there is still significant uncertainty surrounding the details of the plan. The State is negotiating with several smaller unions and needs approval from the General Assembly before enforcing any of the changes set forth in RIRSA. Although still in the implementation stage, this settlement represents a key step in Rhode Island's plan to shore up its pension troubles.

State's economic and demographic trends continue to be poor

Even prior to the onset of the recession, Rhode Island's economy was struggling, with the State's unemployment running more than full percentage point higher than the national rate.[6] Exacerbating their issues, as the recession worsened, Rhode Island's already fragile economy declined disproportionately relative to many of its peers. The recession aggravated the soft underbelly of an already declining manufacturing industry within the State. The number of manufacturing workers in Rhode Island has declined swiftly and immensely, with current levels an astonishing 42% lower than they were in 2000. Manufacturing now accounts for less than 10% of the workforce compared to 15% in 2000. Further hampering Rhode Island's economy has been the lack

[5] "Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System" by Gina M. Raimondo, Rhode Island General Treasurer
[6] In November of 2007 Rhode Island's unemployment rate was 5.9% compared to the National rate of 4.7%, Bureau of Labor Statistics website: www.bls.gov

of any other industry to pick up the slack for the manufacturing sector. The losses of employment in manufacturing, construction, finance, government, and leisure have all outpaced both the nation and its New England peers.[7] All of these factors have led to a precipitous rise in Rhode Island's unemployment rate as evidenced by the peak unemployment rate of 11.3% in 2011.[8] As the United States economy started to show signs of improvement in 2013, Rhode Island once again bucked the trend, laying claim to the highest unemployment rate among states for nine consecutive months during the 2013-2014 time periods.

Rhode Island's demographic outlook is also quite bleak. The population has been declining since 2004, the state boasts one of the lowest birth rates in country, and its average age ranks Rhode Island as the ninth oldest state. The State's aforementioned pension and Medicaid issues are at least in part a consequence of the State's weak demographic trajectory which shows few signs of abating.

Rhode Island's size and geography present unique challenges

We have long opined that the key strengths shared by all states are their sovereign ability to generate revenue through taxation, to reduce expenditures, and to push problems onto local governments. While Rhode Island does possess these powers, its size poses unique challenges. Legislators in Rhode Island must be cognizant of tax rates in neighboring states, as its citizens and businesses arguably have the ability to "vote with their feet" more easily than anywhere else in the country. Regardless of a state's size, a change in statewide tax rates has the ability to limit migration into a state or to encourage people to move into neighboring states. In Rhode Island, this factor is magnified since citizens can easily move an hour in any direction and become a resident of another state with lower tax rates without drastically altering their lifestyle. State officials are well aware of this unique constraint, and therefore, understand that when they are faced with budget shortfalls they do not share the same flexibility as other states to raise taxes given the risk that higher taxes will further exacerbate an already troubling demographic outlook.

Conclusion

Gurtin Municipal Bond Management placed a Sell Rating on the State of Rhode Island and sold all client holdings in the state when Rhode Island began to openly discuss non-appropriation for the 38 Studios debt. As another budget cycle has begun, data has emerged painting the picture of a state with significant economic and budgetary challenges and an ever weakening credit profile. As long as these problems remain unsolved, the pressure placed on the State's financial position will continue to grow, magnifying the threat of non-appropriation. While the 38 Studios saga may have been the inflection point that drove our initial decision to move the State to a Sell, we now believe the State's other more chronic problems pose a heightened level of credit risk. We will continue to monitor the State's progress towards improving its political as well as fiscal, economic and demographic trends before again considering its debt for inclusion in our clients' portfolios.

Please feel free to contact us at research@gurtin.com for additional information.

[7] "Rhode Island in the Great Recession: Factors Contributing to its Sharp Downturn and Slow Recovery" by Mary A. Burke of the Federal Reserve Bank of Boston

[8] All unemployment related figures were taken from the Bureau of Labor Statistics website: www.bls.gov

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